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PASS FED BOARD OF GOVERNORS FOR RKROSZNER, PROBITAILLE
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SUBJECT: CENTRAL BANK GOVERNOR ON MONETARY POLICY, GROWTH, TERROR
FINANCE, RE-ENGAGING THE IMF AND U.S. COOPERATION

Ref: Buenos Aires 2576
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Buenos Aires 2486

Summary

1. (SBU) Central Bank Governor Martin Redrado, in a December 5 lunch with the Ambassador, invited a dialogue with USG on GoA monetary policy which he called conservative, slightly contractionary and generally misunderstood. Now, five years after Argentina's economic crisis, Redrado said Argentina remains an "economy in transition" with the adjustment of non-tradable prices incomplete and fundamental macroeconomic variables -- including nominal and real exchange rates and domestic interest rates - yet to settle to a steady state equilibrium. Redrado called the stabilization of Argentina's financial sector a major achievement, noting the progressive reduction of bank exposure to public debt; the re-opening of bank credit lines to middle market companies; and steady improvements in bank capitalization. On growth, he agreed that productive investment to date has been relatively small scale and incremental and said investment at the 25-26% of GDP level was necessary to ensure a soft economic landing and underpin sustainable 5-6% medium term real GDP growth.

2. (SBU) Redrado called anti-money laundering and counter-terrorism finance efforts a central bank priority, asked for additional USG bilateral technical assistance in these areas, and commented that the GoA's draft counter terrorism finance law would soon be submitted to the President's office. He said Argentina is quietly re-engaging with the IMF and hopes to have First Deputy Managing Director Lipsky and Western Hemisphere Director Singh visit in late January. Redrado requested Ambassador's support on his invitation to have Fed Reserve Governor Kroesner attend the central bank's

annual conference in June 2007. End Summary.

Argentina's Reserve Accumulation and Currency Strategy

13. (SBU) Redrado had just returned from an EU/Latin American central bank governors' conference in Madrid. There he presented a BCRA research paper "The Economic Policy of Foreign Reserve Accumulation," which examines the explosive growth of global international reserves largely driven by emerging economies. Redrado noted that the paper examined international liquidity conditions and individual country demand for reserves and concludes that exchange rate flexibility is not a substitute for reserve accumulation and that emerging economies have chosen to combine high international reserve levels with greater exchange rate flexibility as a strategy to face increasing exposure to exogenous shocks.

14. (SBU) Argentine reserves, Redrado noted, had increased to \$30 billion at the end of November, surpassing the \$28 billion level they reached in December 2005 before the GoA paid off its \$9.5 billion debt to the IMF. He called Argentina's currency policy flexible and rejected the "mis-perception" that the currency is significantly undervalued. Now, five years after Argentina's economic crisis, Redrado said Argentina remains an "economy in transition" with the adjustment of non-tradable prices incomplete and fundamental macroeconomic variables -- including nominal and real exchange rates and domestic interest rates -- yet to settle to a steady state equilibrium. As a consequence, he concluded, BCRA policy is not to "fix" the nominal exchange rate at current levels, but rather to actively manage the peso's real effective exchange rate against a basket of international currencies. He referred to Guillermo Calvo's 2001 paper "The Fear of Floating," which argues that countries that say they allow their exchange rate to float

mostly do not.

15. (SBU) In this context, Redrado called the BCRA's monetary policy conservative, slightly contractionary and (likely referring to recent media criticism by renowned Argentine Economist Miguel Angel Broda) generally misunderstood. He invited a dialogue with USG officials on the GoA's monetary policy, explaining that Argentina's financial system had not recovered enough to implement an inflation targeting regime and arguing that the absence of a reference interest rate makes it more reasonable for the BCRA to use broad monetary targets to control inflation. With one-year BCRA paper trading in the 10-11% range, Redrado said real interest rates are now marginally positive. He declined, however, to predict how far the BCRA will permit rates to rise to control inflation. The central bank, he said, is encouraging banks to raise their CD deposit rates, currently in the 8% range, to real positive levels to encourage savings and expanded financial intermediation.

Putting Financial Service Sector House in Order...

16. (SBU) Redrado called the reactivation and stabilization of local credit markets one of his major achievements since taking on the BCRA governorship in September 2004. A key accomplishment has been the progressive reduction of commercial bank exposure to public debt: While maximum permitted exposure to public debt currently stands at 40% of bank assets (to be reduced to 35% in July 2007), current average exposure has dropped to 28%. A second achievement has been the re-opening of bank credit lines to middle market companies here: Bank credit to GDP ratios have risen from 8% in 2002 to 11% in 2006. Finally, Redrado noted the steady improvement in bank capitalization, with a new debt/equity hybrid instruments under development. The lack of interest reference rates at the long end of the yield curve is gradually being addressed, Redrado concluded, with gas pipeline companies TGS and TGN soon to issue a long term bond that will be purchased by private pension funds.

...And Targeting a Soft Landing: Need Investment

¶7. (SBU) Following four years of GDP growth in the 8-9% range, Redrado called the key challenge facing the GoA maintaining steady-state medium term GDP growth in the 5-6% range. While post-crisis Argentine investment levels have recovered to 21-22% of GDP, he noted that fully 30% of current investment has been channeled into real estate development that does not significantly add to Argentina's productive capacity. Redrado agreed that productive investment to date has been relatively small scale and incremental and said that investment at the 25-26% of GDP level - including significant new Greenfield project investment -- will be required to underpin sustainable 5-6% medium term real GDP growth and so ensure a soft economic landing.

Seeks Greater Bilateral Engagement on Terror Finance

¶8. (SBU) Redrado said he had made anti-money laundering and counter-terrorism finance (AML/CTF) a BCRA priority and had set up a specialized bank examination unit (under the BCRA's Banking Superintendency Division) devoted to these activities. (Note: Redrado announced this initiative in late 2005 and the BCRA recently completed preparations for establishing the unit. However, it has not been authorized to begin audits and bank inspections. End Note).

¶9. (SBU) Redrado appreciated U.S. technical assistance on AML/CTF issues via regional GAFISUD initiatives, but asked that the USG put this higher on the bilateral agenda for engagement with the GoA. Specifically, he suggested the U.S. work with ASBA ("Asociacion de Supervisores Bancarios de las Americas," The Association of Bank Supervisors of the Americas) and consider offering training programs to bank inspectors and supervisors. He noted that he had raised this request with Treasury Assistant Secretary Patrick O'Brien, and had also discussed it with IMF and World Bank representatives.

¶10. (SBU) With regards to the GoA's draft counter-terrorism finance law, Redrado stated it was on Economic Minister Felisa Miceli's desk, after which it would go to Legal and Technical Secretary Carlos Zannini, the President's chief legal advisor. (Note: Other sources within the GoA and BCRA say the Justice Minister has already passed the bill to Zannini. However, there are increasing indications that opposition is building to the law, particularly from key supporters of the President, and the word on the street is that the President may decide not to submit it to Congress before its December 29 recess. Redrado has commented in past meetings with Embosfs that failing to present the draft bill to Congress before the FATF mid-February 2007 deadline would have negative consequences for the Argentine financial sector, particularly if FATF responds by issuing a public statement criticizing the GoA for not meeting world terrorism finance standards. See reftels. End Note).

Central Bank June Conference

¶11. (SBU) Redrado noted that he is inviting U.S. Federal Reserve Governor Kroszner to speak at the central bank's annual conference in June. He asked for the Ambassador's support for this effort, calling the conference the most prestigious in South America. (Note: Prior to his 2006 appointment to the Fed, Kroszner was a member of the President's Council of Economic Advisers from 2001 to ¶2003. End Note)

Re-Engaging with the IMF

¶12. (SBU) Redrado noted that the GoA is working to quietly re-engage with the IMF in order to establish more "normal" working relations. A first step will be a late January/early February visit by John Lipsky, First Deputy Managing Director and Anoop Singh, Director of the Western Hemisphere Department on the margins of an already planned IMF trip to Brazil, Chile and Uruguay. Low key meetings for the IMF team are being planned with Redrado, Economy Minister Miceli and Chief of Cabinet Fernandez.

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